annual report 1965

ZAYRE

Financial ***highlights***

	1965	*1964*
Net Sales	$222,166,330	$162,278,267
Net Income	$ 5,100,446	$ 2,966,959
Working Capital	$ 24,759,057	$ 14,307,588
Shareholders' Equity	$ 18,325,134	$ 12,610,044
Per Common Share:		
Net Income	$2.15	$1.26
Shareholders' Equity	$7.63	$5.35

To our shareholders:

We are delighted to report that 1965 was the most successful year in the history of Zayre Corp. We are now realizing the benefits of management's continuing expansion program and the efforts of our employees to make Zayre a soundly-based leader in the self-service discount industry.

Sales and profits reached new record levels in the twelve-month period ended January 29, 1966. Significantly, further growth was also achieved in the percentage of sales brought down to earnings.

Sales and Earnings

This year's volume increase was the greatest in our history, \$59,888,063 or 37 per cent. Total sales (excluding those of leased departments) were \$222,166,330, compared with \$162,278,267 in the prior year.

Net income after taxes increased even more markedly by 72 per cent to \$5,100,446 compared with the previous high of \$2,966,959 earned last year.

Earnings per share were \$2.15, up from \$1.26 last year, based on the average number of shares outstanding and adjusted to reflect the 40 per cent common stock distribution in October 1965.

Financial Position

The company's financial position has reached new levels of maturity and strength reflecting both increased earnings and additional financing.

Net working capital at year end was \$24,759,057 compared with \$14,307,588 last year.

Net worth increased to \$18,325,134, a sharp contrast to the equity of approximately \$5,000,000 just four years ago when Zayre became a publicly owned company. Shareholders' equity on a share basis was \$7.63 compared with \$5.35 last year.

Of great interest to investors, the after-tax return on average invested capital—shareholders' equity—continues at an extremely strong level, 38 per cent this year compared with 30 per cent last year.

As a result of the decision made in late 1964 to accelerate our expansion, the company on May 4, 1965, sold to the public \$6,000,000 of 4⅝ per cent convertible subordinated debentures due May 1, 1985. The debentures were convertible into Zayre common stock at a rate of 43.07 shares per \$1,000 of debentures (after adjustment to reflect the 40 per cent stock distribution.)

The increase in market value of Zayre common stock since that time justified the calling of the entire issue for redemption on March 14, 1966. We are happy to report that all of the debentures were converted, resulting in the issue of 239,471 shares of common stock, and an increase in Zayre equity of approximately \$6,000,000 less certain related expenses. This change has not been reflected in our financial reports since it occurred after the close of our fiscal year.

In the opinion of management our greatly enlarged financial base is more than adequate to support our continuing expansion program.

Industry Appraisal

The favorable industry and economic trends previously noted in our reports have continued during 1965 and to date.

Discounting is rapidly emerging with a well defined operating format—large, well located self-service department stores carrying a broad range of general merchandise and grouped into multiple store organizations. The last few years have seen the strengthening of the major national and regional operators in the industry. Zayre and others are bringing tight chain store controls

to a high level of effectiveness in conducting their operations.

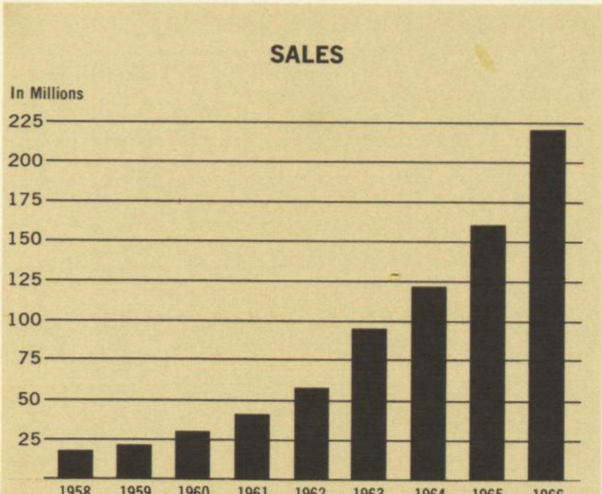
The future growth of the self-service department store industry is assured, since it satisfies two primary suburban consumer needs—sound values and convenience. Convenience is emphasized in many forms including location of stores on major highways, ease of access by automobile, free parking, broad selections of merchandise, self-selection, and evening shopping hours.

The continuing movement of consumers to the suburbs and their increasing familiarity with self-service department stores is creating many new expansion possibilities. We believe that self-service department stores will eventually service all markets in depth and their share of total retail volume will continue to increase.

Expansion Continues

Zayre has continued to grow by the opening of new stores, and the enlargement of its owned lines of merchandise.

During 1965 we opened 12 new Zayre stores compared with 8 in the prior year. The total number of stores in operation at January 29, 1966 was 79, occupying approximately 5,762,300 square feet of retail space. We presently plan to open 15 or more stores in both 1966 and 1967.



To adequately service the expansion contemplated over the next few years, our central distribution facilities in New York City and Framingham, Massachusetts, as well as our Natick, Massachusetts, central offices, will be substantially enlarged. We anticipate that these additions will be placed in operation late in 1966. Consideration is also being given to possible future regional distribution facilities.

We are pleased with the operating progress of the linen, domestics and infants' departments, as well as the stationery and greeting card departments, all of which were acquired in February 1965 from two leased department operators. Both groups of departments have recorded substantial increases in volume during the past year.

Since August 1965, we have operated our own health, beauty aids and candy departments in all new Zayre stores. These departments in the 68 other Zayre stores have an annual sales volume of approximately $13 million and have been operated as leased departments. Arrangements have been concluded for the purchase by Zayre during April 1966 of the inventories of these departments and the assumption of their operation.

As a result of our programs to acquire departments and enlarge the lines of merchandise carried, Zayre owned volume has increased from about 50 per cent of total store volume ten years ago to approximately 75 per cent during 1965.

Management expects the enlargement of its sales base, particularly in lines of merchandise with above average gross margins, will be reflected in time in widening the percentage of sales brought down to earnings.

Zayre Realty Subsidiaries

During 1965 our realty subsidiaries completed the acquisition and financing of two major Zayre

store buildings in Chicago and one each in Cleveland, Atlanta and Tampa. These are in addition to the building acquired during 1964 in Jacksonville, Florida.

In each case 100 per cent financing for the property was arranged by a wholly-owned realty subsidiary with a financial institution. The property was then leased to either Zayre Corp. (parent) or to an operating subsidiary. This lease was assigned as security to the mortgagee along with a guarantee of the rental payments by the parent.

We intend to continue to acquire the ownership of selected store properties on this basis each year. This technique of real estate ownership enables Zayre to achieve somewhat lower rentals, and to retain for the corporation whatever residual equity remains in the property after it is fully amortized.

Other Developments

During the past year we have made considerable further progress in our merchandising, store operations, and sales promotion programs and have achieved a gratifying improvement in the productivity of our stores.

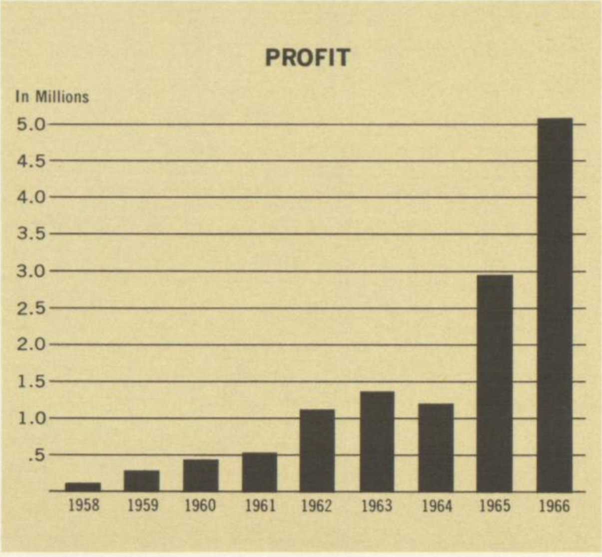
During 1965 our complete credit card program was installed in 11 additional stores and is now available in a total of 24 stores. We will continue to expand this program on a selective basis to those markets where it appears most desirable.

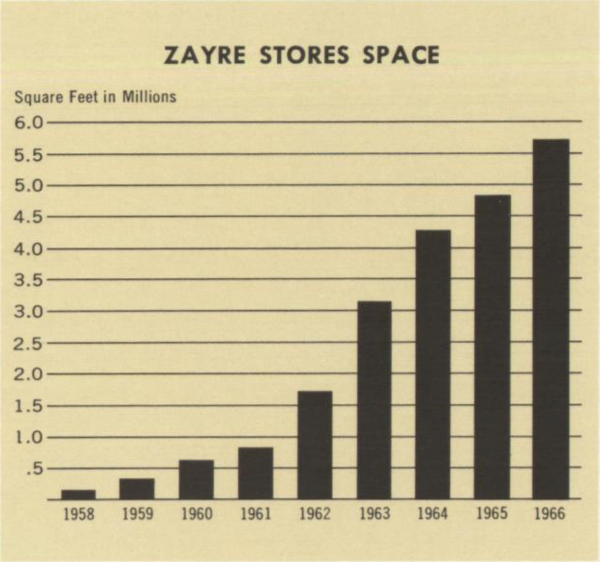
To keep pace with our continuing growth we recently took delivery of an IBM System/360 computer. This equipment will provide us with increased speed and enable us to conduct our operations more efficiently. During the next few years we intend to further improve our data systems and procedures to take maximum advantage of the new equipment and to provide computer assistance for additional merchandise departments.

On November 17, 1965, the common stock of Zayre Corp. moved from the American Stock Exchange to the New York Stock Exchange. This listing confers an additional mark of maturity and financial responsibility on the company.

During the past few years our apparel specialty shops operating under the names "Bell Shops" or "Nugent's" have, pursuant to a planned program, developed a distinctive new identity appealing especially to the sportswear-minded, fashion-conscious junior. During 1965 this division opened 2 new stores and closed 4 older units. At year end, 41 apparel stores were in operation accounting for approximately 4 per cent of total company volume.

In December 1965, your management and the management of Hardlines Distributors, Inc., the operator of leased housewares and hardware departments in all Zayre stores, agreed in principle to a plan whereby Zayre would acquire the net assets of Hardlines in exchange for $850,000 in cash and a new issue of Zayre convertible preferred stock. Since that time, negotiations with respect to this transaction have continued but as yet have not been concluded; and the transaction continues to remain subject to the execution of definitive agreements which have still to be mutually agreed upon and to the fulfillment of various other conditions.





The presentation of our financial statements and data has been enlarged in this Annual Report to reflect Zayre Corp. and All Subsidiaries, a consolidation of the figures of Zayre Corp. and Operating Subsidiaries with those of the Combined Leasing Subsidiaries.

As in the past, the balance sheet of Zayre Corp. and Operating Subsidiaries which deals with our merchandising and store operations has been presented. Management keys its financial planning for operations to this data.

The Leasing Subsidiaries render services that might otherwise be purchased from outside leasing companies and outside real estate developers. The combined balance sheet of Leasing Subsidiaries has also been provided, as in the past, in note J to the financial statements.

Personnel

Our executive training program is a vital factor in assuring the continued success of our growth program. Over 150 qualified executives have completed the program during the past few years and now fill key operating positions in our stores. Currently, over 50 executives are in training.

The increasing profitability of our operations permits the company to fulfill a primary obligation to its employees. On January 1, 1966, a comprehensive non-contributory retirement plan was established to provide coverage for substantially all employees. This program will help the company to attract and hold competent personnel.

The Future

For the national economy the outlook for 1966 appears very good indeed. Above average gains in all the important indices are forecast by the nation's economists. Certainly the American consumer will have more spending power than ever before in history.

The self-service department store sector of retailing, now enjoying increasing consumer acceptance, will continue to attract a larger share of the consumer's disposable income.

Based on current strong sales trends as well as the expansion and acquisition program previously outlined, Zayre should achieve a major increase in volume during 1966. Management anticipates that earnings should keep pace with our growth in sales.

Finally, it is our privilege to once again thank our hard working and dedicated employees for their splendid efforts in behalf of the company during 1965. Certainly the excellent results of the past year are a remarkable tribute to their teamwork and effectiveness.

Respectfully submitted,

M. Feldberg — Stanley H. Feldberg

MORRIS FELDBERG, *Chairman*

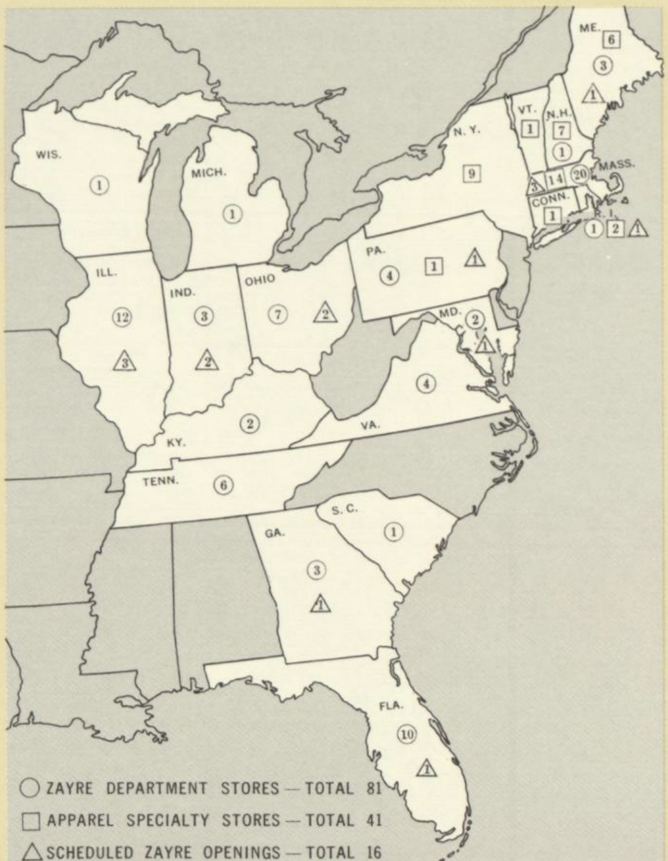
STANLEY H. FELDBERG, *President*

April 15, 1966

Zayre Corp. Stores

Zayre plans to open fifteen or more new stores in 1966. Most new Zayre stores will be located in major metropolitan markets in which the company already has a sales base.

We will open four stores in Chicago bringing the total operated to 13 and two units in Boston making a total of 11. So far this year we have opened new stores in Miami, Florida; (West Hollywood) and Columbus, Ohio. Stores will also be added in the following markets: Atlanta, Georgia (Smyrna); District of Columbia (Lanham); Pittsburgh, Pennsylvania (Baden); Providence, Rhode Island; Indianapolis, Indiana; Waterville, Maine; Toledo, Ohio and Cleveland, Ohio (Mentor).



Florida — **JACKSONVILLE** (2) Beach Blvd., Normandy Blvd. - **MIAMI** (6) Coral Way, Fort Lauderdale (2), Hialeah, North Miami Beach, West Hollywood — **TAMPA** (2) East Hillsborough, Gandy Blvd.

Georgia — **ATLANTA** (3) Buford Highway, Cascade Avenue, Stewart Avenue

Illinois — **CHAMPAIGN - CHICAGO** (9) Ashland, Bridgeview, Columbus Avenue, Des Plaines, Forest Park, Joliet, Markham, Oaklawn, Palatine - **ROCK ISLAND — SPRINGFIELD**

Indiana — **INDIANAPOLIS** (3) East 10th Street, Pendleton Pike, South East Highway

Kentucky — **LOUISVILLE** (2) Bardstown Road, Dixie Highway

Maine — **BANGOR - PORTLAND - PRESQUE ISLE**

Maryland — **DISTRICT OF COLUMBIA** (2) Silver Springs, Wheaton

Massachusetts — **BOSTON** (9) Beverly, Braintree, Cambridge, Medford, Natick, Roslindale, Saugus, Waltham, Woburn - **FALL RIVER - GREAT BARRINGTON - HADLEY - HYANNIS - LOWELL - PITTSFIELD - SPRINGFIELD** (3) Agawam, Boston Road, Chicopee - **WORCESTER** (2) Lincoln Street, Stafford Street

Michigan — **KALAMAZOO**

New Hampshire — **MANCHESTER**

Ohio — **CINCINNATI** (2) Paxton Avenue, Princeton Pike - **CLEVELAND** (3) North Olmsted, Ridge Road, Warrensville Heights - **COLUMBUS** (2) East Main Street, West Broad Street.

Pennsylvania — **PITTSBURGH** (3) Monroeville, McKeesport, McKnight Road - **WILKES-BARRE**

Rhode Island — **EAST PROVIDENCE**

South Carolina — **COLUMBIA**

Tennessee — **CHATTANOOGA - KNOXVILLE - MEMPHIS** (2) Poplar Avenue, Summer Avenue - **NASHVILLE** (2) Gallatin Road, Murfreesboro Road

Virginia — **DISTRICT OF COLUMBIA** (2) Alexandria, Falls Church - **PORTSMOUTH - RICHMOND**

Wisconsin — **RACINE**

Apparel Specialty Shops

Connecticut — **NORWICH**

Maine—**AUGUSTA-BIDDEFORD-LEWISTON-PORTLAND - ROCKLAND - SKOWHEGAN**

Massachusetts — **BOSTON - FALL RIVER - FRAMINGHAM - GLOUCESTER - LAWRENCE - LOWELL - LYNN - MALDEN - PITTSFIELD - QUINCY - SALEM - SPRINGFIELD - TAUNTON - WORCESTER**

New Hampshire — **BERLIN - CONCORD - KEENE - MANCHESTER** (2) - **NASHUA - ROCHESTER**

New York — **AUBURN - ENDICOTT - GLENS FALLS - JAMESTOWN - KINGSTON - NIAGARA FALLS - OLEAN - POUGHKEEPSIE - WATERTOWN**

Pennsylvania — **ERIE**

Rhode Island — **NEWPORT - PAWTUCKET**

Vermont — **NEWPORT**

Zayre Store Openings Now Scheduled

Florida — **WEST PALM BEACH**

Georgia — **ATLANTA** (Smyrna)

Illinois — **CHICAGO** (3)

Indiana — **HAMMOND - INDIANAPOLIS**

Maine — **WATERVILLE**

Maryland—**DISTRICT OF COLUMBIA** (Lanham)

Massachusetts — **BOSTON** (2) - **METHUEN**

Ohio — **CLEVELAND** (Mentor) - **TOLEDO**

Pennsylvania — **PITTSBURGH** (Baden)

Rhode Island — **PROVIDENCE**

Nine-Year Summary of Progress

Fiscal Years Ended Last Saturday in January	1966	1965	1964
Operating Data:			
Net Sales (excluding sales of leased departments)	$222,166,330	$162,278,267	$122,810,651
Earnings Before Federal Income Taxes (1)	$ 8,890,446	$ 5,146,959	$ 2,079,179
Net Income (1)	$ 5,100,446	$ 2,966,959	$ 1,222,879
Average Number of Shares Outstanding (2)	2,373,470	2,354,519	2,354,100
Earnings per Share (1) (2)	$2.15	$1.26	$.52
Stores in Operation:			
Zayre Department Stores	79	69	61
Apparel Specialty Shops	41	43	46
Financial Position:			
Current Assets	$ 44,182,466	$ 27,827,857	$ 26,261,532
Current Liabilities	$ 19,423,409	$ 13,520,269	$ 13,329,510
Working Capital	$ 24,759,057	$ 14,307,588	$ 12,932,022
Shareholders' Equity	$ 18,325,134	$ 12,610,044	$ 9,616,295
Number of Shares Outstanding at Year End (2)	2,400,787	2,357,390	2,354,100
Shareholders' Equity per Share (2)	$7.63	$5.35	$4.08

Zayre Corp. and All Subsidiaries

1963	1962	1961	1960	1959	1958
$96,431,611	$59,165,743	$41,942,064	$31,372,742	$22,001,541	$18,516,155
$ 2,359,594	$ 2,003,736	$ 1,062,697	$ 903,148	$ 517,338	$ 201,776
$ 1,374,494	$ 1,126,736	$ 541,697	$ 441,148	$ 295,338	$ 143,776
2,190,766	2,109,100	2,109,100	2,109,100	2,109,100	2,109,100
$.63	$.53	$.26	$.21	$.14	$.07
47	27	14	11	6	4
48	52	59	61	64	70

1963	1962
$18,464,716	$11,467,893
$10,129,088	$ 7,347,858
$ 8,335,628	$ 4,120,035
$ 8,393,416	$ 4,957,270
2,354,100	2,109,100
$3.57	$2.35

(1) Income for fiscal 1963 and prior years includes pro forma adjustments which give effect to the ownership of assets acquired from Feldberg Five Fund on March 1, 1962.

(2) Adjusted to reflect the 40% common stock distribution during October, 1965.

Ground Breaking to Gra

GROUND BREAKING — Company and construction officials attend traditional ceremonies.

Steel work for modern building is in place and exterior walls a
struction 25 days later.

Zayre stores are located in modern well-designed one-story air-conditioned buildings, situated on major highways with easy access to free parking.

The accompanying step-by-step photographs of the Fort Lauderdale, Florida stores graphically depict the coordination required to build, equip and stock a new Zayre self-service department store.

After 50 days glass
is also under way.

GRAND OPENING

(at right)

Throngs of happy bargain hunters jam store on opening day.

(at extreme right)

Overflow crowd, attracted by grand opening advertising program, jams parking lot.

nd Opening in 137 Days

re under con-

After 40 days store is completely enclosed and flooring is being laid.

ront is being installed. Grading and paving of parking lot

Modern specially designed fixtures are installed 60 days before grand opening.

Zayre Corp. and Operating Subsidiaries

Consolidated Balance Sheets (note A)

	Jan. 29, 1966	Jan. 30, 1965
Assets		
CURRENT ASSETS:		
Cash	$ 3,540,888	$ 3,277,386
U. S. Treasury Bills	2,997,363	
Accounts Receivable	2,807,092	1,486,502
Merchandise Inventories, at the lower of cost (retail method) or market	33,269,751	21,645,603
Due from Leasing Subsidiaries (note J)		707,437
Prepaid Expenses	857,356	860,571
Total Current Assets	43,472,450	27,977,499
Equity in Wholly Owned Unconsolidated Leasing Subsidiaries (note J)	1,628,368	1,156,420
Equipment and Leasehold Improvements, at cost	2,289,867	1,917,398
Less accumulated depreciation and amortization	1,176,543	1,129,013
	1,113,324	788,385
Preopening Expenses, at amortized cost (note C)	503,473	244,171
Deferred Charges and Other Assets	872,058	545,459
	$47,589,673	$30,711,934
Liabilities		
CURRENT LIABILITIES:		
Current Instalments of General Corporate Debt	$ 127,958	$ 128,684
Accounts Payable	9,388,230	5,728,941
Sales Taxes, Payroll Withholdings, and Collections for Leased Departments	1,556,172	1,580,440
Accrued Expenses	2,590,716	1,774,400
Federal Income Taxes	2,955,727	1,942,360
Total Current Liabilities	16,618,803	11,154,825
General Corporate Debt, exclusive of current instalments (note B)	6,875,000	6,827,958
Deferred Federal Income Taxes (note C)	208,736	119,107
Commitments (notes E, F, and J)		
Convertible Subordinated Debentures (subsequently converted into common stock — note D)	5,562,000	
Shareholders' Equity		
Common Stock, par value $1, authorized 3,000,000 shares, issued and outstanding 2,400,787 shares (notes D, G, H, I)	2,400,787	1,881,178
Additional Paid-in Capital	2,176,984	2,371,949
Retained Earnings (note B)	13,747,363	8,646,917
	18,325,134	12,900,044
Less 197,328 shares of stock in treasury, at cost (note G)		290,000
		12,610,044
	$47,589,673	$30,711,934

Zayre Corp. and All Subsidiaries

Consolidated Balance Sheets

	Jan. 29, 1966	Jan. 30, 1965
Assets		
CURRENT ASSETS:		
CASH	$ 4,089,582	$ 3,823,100
U. S. TREASURY BILLS	2,997,363	
ACCOUNTS RECEIVABLE	2,968,414	1,498,583
MERCHANDISE INVENTORIES, at the lower of cost (retail method) or market	33,269,751	21,645,603
PREPAID EXPENSES	857,356	860,571
TOTAL CURRENT ASSETS	44,182,466	27,827,857
PROPERTY, EQUIPMENT AND LEASEHOLD IMPROVEMENTS, at cost:		
LAND	1,166,096	54,200
BUILDINGS	7,001,501	815,854
LEASEHOLD IMPROVEMENTS	2,356,202	1,790,721
FURNITURE, FIXTURES AND EQUIPMENT	17,697,292	14,366,297
	28,221,091	17,027,072
Less accumulated depreciation and amortization	6,414,267	4,767,476
	21,806,824	12,259,596
PREOPENING EXPENSES, at amortized cost (note C)	503,473	244,171
DEFERRED CHARGES AND OTHER ASSETS	928,823	549,821
	$67,421,586	$40,881,445
Liabilities		
CURRENT LIABILITIES:		
CURRENT INSTALMENTS OF LONG-TERM DEBT	$ 2,318,151	$ 2,324,989
ACCOUNTS PAYABLE	9,751,790	5,777,457
SALES TAXES, PAYROLL WITHHOLDINGS, AND COLLECTIONS FOR LEASED DEPARTMENTS	1,556,172	1,580,440
ACCRUED EXPENSES	2,778,169	1,859,394
FEDERAL INCOME TAXES	3,019,127	1,977,989
TOTAL CURRENT LIABILITIES	19,423,409	13,520,269
LONG-TERM DEBT, exclusive of current instalments (note B):		
GENERAL CORPORATE DEBT	6,875,000	6,827,958
EQUIPMENT PROMISSORY NOTES	8,464,550	7,336,408
REAL ESTATE MORTGAGES	7,849,757	
DEFERRED FEDERAL INCOME TAXES (note C)	921,736	586,766
COMMITMENTS (notes E and F)		
CONVERTIBLE SUBORDINATED DEBENTURES (subsequently converted into common stock — note D)	5,562,000	
Shareholders' Equity		
COMMON STOCK, par value $1, authorized 3,000,000 shares, issued and outstanding 2,400,787 shares (notes D, G, H, I)	2,400,787	1,881,178
ADDITIONAL PAID-IN CAPITAL	2,176,984	2,371,949
RETAINED EARNINGS (note B)	13,747,363	8,646,917
	18,325,134	12,900,044
Less 197,328 shares of stock in treasury, at cost (note G)		290,000
		12,610,044
	$67,421,586	$40,881,445

The accompanying notes are an integral part of the financial statements.

Zayre Corp. and All Subsidiaries

Consolidated Statements of Income and Retained Earnings

	Fiscal Years Ended Jan. 29, 1966	Fiscal Years Ended Jan. 30, 1965
Net sales, excluding sales of leased departments	$222,166,330	$162,278,267
Rentals from leased departments, net of estimated allocated store expenses	1,505,623	1,614,309
Other income	569,484	312,202
	224,241,437	164,204,778
Cost of sales, including buying and occupancy costs	182,403,397	135,146,774
Selling, general and administrative expenses	29,328,415	20,801,755
Depreciation and amortization	2,373,382	2,057,655
Interest expense	1,245,797	1,051,635
	215,350,991	159,057,819
Income before provision for federal income taxes	8,890,446	5,146,959
Provision for federal income taxes (note C)	3,790,000	2,180,000
Net income	5,100,446	2,966,959
Retained earnings at beginning of year	8,646,917	5,679,958
Retained earnings at end of year	$ 13,747,363	$ 8,646,917

Consolidated Statements of Additional Paid-in Capital

	Jan. 29, 1966	Jan. 30, 1965
Balance at beginning of year	$ 2,371,949	$ 2,347,509
Excess of cost over par value of 197,328 treasury shares changed to authorized but unissued common stock	(92,672)	
Transfer to common stock account for par value of 678,693 shares distributed in seven-for-five stock split and payments of $4,076 in lieu of fractional shares (note G)	(682,769)	
Excess of conversion price over par value of 18,859 shares of common stock issued in exchange for convertible subordinated debentures, net of related unamortized debt expense	405,297	
Excess of net cash proceeds over par value of common stock issued upon exercise of stock options	175,179	24,440
Balance at end of year	$ 2,176,984	$ 2,371,949

The accompanying notes are an integral part of the financial statements.

Zayre Corp. and All Subsidiaries

Consolidated Statements of Funds

	Fiscal Years Ended Jan. 29, 1966	Fiscal Years Ended Jan. 30, 1965
Source		
Net Income	$ 5,100,446	$ 2,966,959
Charges to income not requiring current expenditures of funds:		
Depreciation and amortization	2,373,382	2,057,655
Deferred federal income taxes	334,970	177,300
Funds provided from operations	7,808,798	5,201,914
Net increase in long-term debt	9,024,941	
Sale of convertible subordinated debentures (net proceeds)	5,807,860	
Common stock issued upon exercise of options and conversion of debentures	618,719	26,790
	$23,260,318	$ 5,228,704
Application		
Land and buildings	$ 7,291,042	$ 870,055
Furniture, fixtures, equipment and leasehold improvements (net additions)	4,043,562	1,736,162
Preopening costs	714,703	377,712
Deferred charges and other assets	335,386	47,231
Net reduction in long-term debt		821,978
Reduction in convertible subordinated debentures as a result of conversions	424,156	
	12,808,849	3,853,138
Increase in working capital	10,451,469	1,375,566
	$23,260,318	$ 5,228,704

The accompanying notes are an integral part of the financial statements

Auditors' Report

To the Board of Directors of ZAYRE CORP.:

We have examined the consolidated balance sheet of Zayre Corp. and All Subsidiaries as of January 29, 1966, the related consolidated statements of income and retained earnings and additional paid-in capital, and the consolidated statement of funds for the fiscal year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances. We previously examined and reported upon the financial statements for the fiscal year ended January 30, 1965, which have been restated with our concurrence, as described in note A of notes to consolidated financial statements.

In our opinion, the aforementioned financial statements present fairly the consolidated financial position of Zayre Corp. and All Subsidiaries at January 29, 1966 and January 30, 1965, the consolidated results of their operations, and the consolidated source and application of their funds for the fiscal years then ended, in conformity with generally accepted accounting principles applied on a consistent basis.

Lybrand, Ross Bros. & Montgomery

LYBRAND, ROSS BROS. & MONTGOMERY

Boston, Massachusetts
April 5, 1966

Notes to Consolidated Financial Statements

A — Basis of Presentation

In fiscal 1966, the Company adopted the policy of consolidating the financial statements of all of its subsidiaries in order to include the properties and related debt of its leasing subsidiaries. The financial statements for fiscal 1965 have been restated on the same basis. This change in presentation has no effect upon net income of either year. The consolidated balance sheets of Zayre Corp. and Operating Subsidiaries (which exclude the aforementioned properties and debt) are presented for supplemental comparative purposes and the combined balance sheets of the Company's leasing subsidiaries are reflected in note J.

B — Long-term Debt

At January 29, 1966, long-term debt, exclusive of current instalments and exclusive of the Company's 4⅝% convertible subordinated debentures (see note D), consisted of the following:

General corporate debt	
6% promissory note, payable $60,000 semi-annually, balance due April 1, 1976	$ 1,200,000
5.8% promissory notes, payable $250,000 annually commencing January 31, 1967, balance due January 31, 1978	3,000,000
5½% subordinated notes, payable $200,000 annually commencing January 15, 1968, balance due January 15, 1979	2,500,000
Other long-term debt	175,000
	6,875,000
Equipment promissory notes, payable $209,046 monthly including interest at 5% to 5½%, maturing May 1, 1967 to November 1, 1975	8,464,550
Real estate mortgages, payable $310,529 semi-annually including interest at 5½% to 5.9%, maturing May 1, 1985 to January 6, 1991	7,849,757
	$23,189,307

The 5½% subordinated notes are subordinated to the 6% and 5.8% promissory notes. A description of the stock purchase warrants issued in connection with the 5½% subordinated notes is set forth in note I.

Under provisions of the agreements governing long-term debt, $6,050,000 of retained earnings was available for dividends at January 29, 1966.

While the parent company is not directly obligated with respect to the equipment promissory notes or real estate mortgages, it has guaranteed the leases which have been assigned as security for such debt, and it has also agreed to provide additional financing to the real estate subsidiaries under certain circumstances.

C — Federal Income Taxes

Deferred federal income taxes arise from: (a) the use of an accelerated method for computing depreciation for tax purposes, whereas the straight line method is used for financial reporting purposes, and (b) the deduction for tax purposes of preopening expenses in the year in which a store opens, whereas such expenses are amortized over a twelve month period for financial reporting purposes. The provisions for federal income taxes include $335,000 deferred in fiscal 1966 and $177,000 deferred in fiscal 1965.

The companies have reduced the provisions for current and deferred federal income taxes by the applicable investment credit. In the aggregate, $256,000 of available investment credit was used to reduce provisions for federal income taxes in fiscal 1966 and $308,000 in fiscal 1965. Approximately $69,000 of unused investment credit is available for reduction of future taxes.

D — Convertible Subordinated Debentures

In May, 1965, the Company sold $6,000,000 of 4⅝% convertible subordinated debentures. During fiscal 1966, $438,000 of the debentures were exchanged for 18,859 shares of common stock at a price of $23.216 per share. The balance of the debentures was converted into 239,471 shares of the Company's common stock subsequent to fiscal 1966, also at a price of $23.216 per share, principally as a result of the Company's call for a March 14, 1966 redemption.

E — Commitments

Under the long-term leases, expiring after fiscal 1969 (principally from 1982 to 1992), the companies are committed to pay minimum annual rentals of approximately $7,800,000, exclusive of, in many instances, real estate taxes, insurance, maintenance and additional rentals based upon sales. Additional minimum annual rentals of approximately $425,000 will be payable under long-term leases for stores not yet opened.

Commitments of approximately $3,700,000 are outstanding for the purchase of land and furniture and fixtures, principally for new stores. One of the companies is committed to purchase presently leased land and a store building for $1,950,000, if and when title can be delivered.

In April, 1966, the companies agreed to purchase for approximately $1,600,000 the inventories of the health, beauty aids and candy departments now leased to an independent operator in 68 Zayre stores.

In December, 1965, the management of the Company and of Hardlines Distributors, Inc. (operators of leased housewares and hardware departments in all Zayre stores and other discount department stores), agreed in principle that the Company would exchange $850,000 cash and a new issue of convertible preferred stock for the net assets of Hardlines. Negotiations with respect to this transaction are still continuing.

F — Retirement Plan

The Company established a non-contributory, funded employee Retirement Plan on January 1, 1966. Generally, employees who have completed three years of continuous service and have attained the age of thirty become members of the Plan. The normal retirement age is sixty-five, but the Plan contains provisions for earlier or later retirement. Retirement benefits are based upon compensation and years of service, subject to a minimum benefit. The actuarially determined cost of the Plan for the first year, approximately $364,000, has been charged to income in fiscal 1966. It is the Company's intention to amortize the unfunded past service costs, approximately $1,170,000, over thirty years.

G — Stock Distribution

Pursuant to the Board of Directors' approval of a stock distribution of two shares for every five shares outstanding, stockholders of record on October 1, 1965 received 678,693 shares of the Company's common stock, including 197,328 shares previously held in treasury. Option, warrant and conversion prices and other per-share data have been adjusted to give effect to the 40% stock distribution which has been treated, for accounting purposes, as a seven-for-five stock split.

H — Stock Options

Under its Stock Option Plans, the Company has granted options to certain officers and key employees entitling them to purchase shares of common stock within five years from the grant date at option prices of 100% (1965 Plan) or 95% to 100% (1962 Plan) of market price on the grant date. Generally, all options are exercisable in four equal cumulative annual instalments commencing one year after the grant date. The 1962 Plan was terminated during fiscal 1966, except as to options outstanding thereunder. Unissued common stock reserved for options aggregated 97,650 shares at January 29, 1966 and 66,710 shares at January 30, 1965. Information concerning current year activity follows:

		Number of Shares	
	Option Prices	Issuable under Options Granted	Available for Future Options
Outstanding at 1/30/65	$7.06 to $8.15	52,990	13,720
Termination of 1962 Plan			(13,720)
Authorized under 1965 Plan			70,000
Options granted	$20.90 to $34.25	32,420	(32,420)
Options exercised	$7.06 to $8.15	(24,675)	
Cancellations		(665)	
Outstanding at 1/29/66	$7.06 to $34.25	60,070	37,580

The foregoing shares and related prices have been adjusted for the seven-for-five stock split (note G). Included in the number of options exercised are 5,290 shares issued as a result of the stock split.

I — Stock Purchase Warrants

There were outstanding at January 29, 1966, Class A and Class B warrants for the purchase of 87,534 and 52,489 shares, respectively, of the Company's common stock. Through July 15, 1971, the purchase price at which they are exercisable is $7.14 for Class A warrants and $8.93 for Class B warrants. Both classes are exercisable thereafter at $10.71 per share through January 15, 1979, when they expire. The exercise prices are subject to antidilution provisions and the number of shares which can be purchased under the warrants is subject to adjustment for recapitalizations and similar events. The Company has reserved 140,023 shares of its authorized common stock for the warrants. None of these warrants have been exercised.

J — Combined Balance Sheets of the Leasing Subsidiaries of Zayre Corp.

Assets	*Jan. 29, 1966*	*Jan. 30, 1965*
Property, equipment and leasehold improvements, at cost:		
Land and buildings	$ 8,167,597	$ 870,054
Furniture, fixtures, and leasehold improvements	17,763,627	14,239,620
	25,931,224	15,109,674
Less accumulated depreciation and amortization	5,237,724	3,638,463
	20,693,500	11,471,211
Cash	548,694	545,714
Accounts receivable	182,108	12,081
Other assets	56,765	4,362
	$21,481,067	$12,033,368
Liabilities		
Long-term debt, including current instalments of $2,190,193 in 1966 and $2,196,305 in 1965 (note B)	$18,504,500	$ 9,532,713
Accounts payable and accrued expenses	635,199	169,139
Due to parent and operating subsidiaries		707,437
Deferred federal income taxes	713,000	467,659
	19,852,699	10,876,948
Equity	1,628,368	1,156,420
	$21,481,067	$12,033,368

Fixed annual rentals are payable, under long-term leases, by the parent company and its operating subsidiaries for the use of real estate, furniture, fixtures and leasehold improvements owned by the leasing subsidiaries. These leases are pledged as collateral for the related debt of the leasing subsidiaries and are directly or indirectly guaranteed by the parent company.

Board of Directors

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Chairman

MAX FELDBERG
Vice Chairman and Executive Vice President

ABRAM BERKOWITZ
Partner, Ropes & Gray

STANLEY H. FELDBERG
President

SUMNER L. FELDBERG
Senior Vice President and Treasurer

NEWTON A. LANE
Partner, Nathanson & Rudofsky

MILTON L. LEVY
Senior Vice President

BURTON S. STERN
Senior Vice President

MORRIS NATELSON
Partner, Lehman Brothers

Officers

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Chairman of the Board

MAX FELDBERG
Vice Chairman of the Board and Executive Vice President

STANLEY H. FELDBERG
President

SUMNER L. FELDBERG
Senior Vice President and Treasurer

MILTON L. LEVY
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BURTON S. STERN
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NEWTON A. LANE
Secretary

NORMAN LENOX
Assistant Vice President and Assistant Secretary

THEODORE SCHOENFELD
Assistant Vice President—Merchandising

TRANSFER AGENTS

State Street Bank and Trust Company, Boston, Massachusetts
Irving Trust Company, New York, New York

GENERAL COUNSEL

Nathanson & Rudofsky

AUDITORS

Lybrand, Ross Bros. & Montgomery
Touche, Ross, Bailey & Smart

REGISTRARS

The First National Bank of Boston, Boston, Massachusetts
The Chase Manhattan Bank, New York, New York

SPECIAL COUNSEL

Ropes & Gray

LISTING

New York Stock Exchange

DISTRIBUTION CENTERS

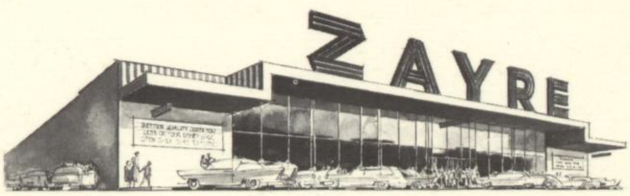
Framingham, Mass. — Natick, Mass. — New York, New York

ANNUAL MEETING

The by-laws of the Company have recently been amended to provide that the annual meeting will be held on the first Tuesday in June of each year. The 1966 annual meeting will be held at 11:00 A.M. on Tuesday, June 7, 1966 in the Auditorium, State Street Bank and Trust Company, 225 Franklin Street, Boston, Massachusetts.

ZAYRE CORP.

ONE MERCER ROAD, NATICK, MASS.



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